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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

DEPUTY ASSISTANT SECRETARY

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December 31, 1981
WHITE HOUSE
SITUATION ROOM

MEMORANDUM

To: Admiral John Poindexter
National Security Council

From: R.A. Cornell
Deputy Assistant Secretary
Trade & Investment Policy

Subject: Treasury Analysis of the Tank Clause

Attached is a Treasury staff analysis and views on the option of invocation of the "Exceptional Circumstances" or "Tank" clause of the Multilateral Debt Rescheduling Agreement with Poland for 1981. This piece has not been reviewed by either Secretary Regan or Deputy Secretary McNamar, but it has been discussed with Mr. McNamar.

We will appreciate your distributing it to all agencies involved in this Saturday's SSG meeting.

cc: Deputy Secretary McNamar
Assistant Secretary Leland

~~SECRET~~Analysis of "Exceptional Circumstances Clause" Invocation

- This is a major item under consideration by NSC Staff for the next round of retaliatory measures.
- The April 27, 1981 Agreed Minute on Poland's external debt to official creditors contains an exceptional circumstances clause whereby participating countries can suspend, without notice, their debt rescheduling agreement with Poland.
- This clause was inserted because the official creditors did not want to be in the position of providing financial assistance to the GOP if the Soviets intervened directly or if the GOP acted to reimpose a repressive regime.
- As a practical matter, we are obliged to consult with other creditor countries prior to taking this step.
- There is general agreement among the creditor countries that circumstances in Poland justify invocation of this clause. However, doing so now would be counterproductive because the threat of utilizing this clause is judged to be greater than its actual imposition since the effects would have little, if any, real economic significance for Poland at present.
- Under current circumstances -- repression but no overt Soviet intervention -- there is no indication others would be willing to invoke this clause in the near future, unilaterally or multilaterally.
- Senior representatives of the UK, FRG, French and U.S. governments agreed on December 22, 1981 that this matter should be discussed by Poland's 16 creditor countries, including such non-NATO countries as Japan, Sweden and Austria on January 14 and 15, 1982, so that we can reach a unanimity of views on violation of the clause.
- If this exceptional circumstance clause is invoked, the terms of the original debt contracts for the payment of principal and interest would be reinstated. In this event, the Poles would not be able to meet their debt obligations to U.S. Government agencies.
- If USG invoked "exceptional circumstances" clause, it's not 100 percent certain that U.S. banks would -- or could -- provoke default of all Polish private

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syndicated debt. Views of lead bank in each syndicate and other (West European and Japanese) members need to be considered; they might prefer to sit tight.

- Non-payment by the Poles would enable the banks to declare default and attempt to attach assets on a worldwide basis. The bulk of Polish borrowings from the West were in the form of internationally-syndicated loans without collateral. In reality, there is little the creditors could attach, apart perhaps from Polish ships or cargoes entering Western ports or the national airline's airplanes. If the Poles (or Russians) viewed such action as deliberate economic warfare, they might be tempted to repudiate debt to selective creditors, and possibly attempt to work on rescheduling with others.
- The ensuing chaos would severely disrupt, but not stop, Polish trade which could go out through third parties. It would probably terminate the GOP's small debt repayments which are being made to both public and private creditors. Thus, it is highly doubtful whether this step could further punish the GOP in any economically significant way.

Effect on Bloc Countries

- It is doubtful whether Eastern European countries or the Soviet Union would default on their debts to Western creditors for political or retaliatory reasons, as this step would largely terminate their ability to obtain Western goods and agricultural commodities. However, Western private lending to Eastern Europe would be largely curtailed, at least in the short run.
- If official financing were not available, Romania would be forced to reschedule or default on its debts. The East Germans (GDR) and Yugoslavia (a non Soviet Bloc country) would probably be hard pressed financially. The GDR can quite likely count on receiving assistance from West Germany and the Western Allies would probably mount a multilateral effort to assist Yugoslavia.
- Of the other Eastern European countries, only Hungary would be significantly affected by a cutoff of Western private credit. The Hungarians have clearly demonstrated their economic managerial talents in the past and could be expected to cope with this development, albeit with some difficulty.

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Effect on Other Countries

- Brazil currently holds \$1.4 billion in Polish debt, all official trade credits for Brazilian products which are mostly agricultural goods.
- Scheduled amortization of Polish debt to Brazil is believed to have been \$260 million. In mid-November, Brazil reportedly reached agreement with Poland to defer payment on all but \$26 million of this obligation. Interest was to be paid on schedule.
- If Poland unilaterally suspended all debt service payments, Brazil would probably suspend all exports, except on a "cash and carry" basis. It would attempt to keep the problem strictly bilateral and would not be interested in sanctions and reprisals against the USSR.

B. Impact on Western Financial MarketsBy country/banking system

- Leaving aside the cost of default to Western Governments (\$10 billion), Polish default on all commercial debt would cost private banks over \$9 billion (aside from government guaranteed debt), of which \$1.3 billion owed to U.S. banks.
- None of major countries' national banking systems involved (Germany, Austria, France, Italy, and the U.S.), would suffer major shock if Poland defaulted. Effects would be contained -- although some individual German and Austrian banks would be hard-hit; U.S. banks would show reduced profits; with nationalized commercial banks in France and Italy, governments of those countries would effectively bear losses; so would all governments involved to degree that banks' losses were reduced by tax writeoffs. There could also be problem with LDC lenders (like Brazil), although effects not quantifiable.
- If a default became Bloc-wide, involving up to \$50 billion in claims of private banks in major industrialized countries, the entire Western banking system could grind to a halt while ramifications and damage were assessed; trade with Eastern Bloc would dry up; massive uncertainty, loss of confidence would ensue; central banks and regulators of G-10 countries would have major job to reassemble pieces;

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bank shareholders would suffer considerable loss; underlying faith in viability of Free World financial system could be shaken; it might affect OPEC producers -- i.e., which private bankers could they trust.

Systemic Impact

- Some form of above scenario (involving defaults, attempts to seize assets, heavy bank losses, breakdown of payments mechanisms, resulting uncertainty and potential panic in domestic financial markets) would impair trade among Western countries and also would have long-term negative effects on U.S. banks' international operations.
- EC countries, possibly Scandinavian, Swiss, Austrian, and Japanese, might form defensive circle, mitigate or prevent default situation being declared by their banks, possibly offset or counter U.S. actions.

Damage Control

- Governments and central banks would have to try to save financial institutions which suffered runs because of market distrust, at considerable cost. USG would be held responsible for situation and called upon to share other countries' burden.
- Exporters to Bloc would demand compensation for losses. Substantial financial assistance necessary.

A Note on Romania

- Romania is likely to seek a debt rescheduling in 1982.
- This action is expected to come in the form of a recommendation by the Fund staff in any renewed agreement they may reach with the Romanians.
- At IMF Board consideration of such an agreement, we would have the opportunity to reject that recommendation.
- Should we decide not to reschedule, or to delay rescheduling, other creditors would be unlikely to reschedule since their doing so in effect would finance the payments due to the USG.
- Thus, for the limited amount of debt service owed to the USG (about \$30 m in 1982), we can exert significant leverage over the Western Europeans who are Romania's largest creditors.

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CONCLUSION

-- The thrust of a key issue before us is whether we wish to use the financial sector of our economy through implementation of the "exceptional circumstances" clause, in an attempt to realize the objectives of other possible retaliatory measures (chiefly a trade embargo) associated with the productive sectors of our economy, primarily agriculture.

-- Seeing that measures such as a trade embargo would be enormously costly to the USG and the U.S. economy, as well as unlikely to evoke allied cooperation, those who are attracted by the idea of invoking the "tank clause" see two advantages: (1) it would force the the allies to cooperate by threatening their financial systems through a unilateral U.S. action; and (2) it would be poorly understood domestically and therefore less likely to be unpopular.

-- We believe that to involve the "tank clause" would be unwise for the following reasons:

-- There are no assurances that invocation of the clause would bring about the desired effects on Soviet and Eastern Bloc access to Western financial markets so as to reduce substantially or halt credit sales of grain (or other products) to the U.S.S.R.

-- Invocation of the clause could prove extremely costly to the United States and the West. If only Poland were to default, it would be costly, but the damage could be contained. If it resulted in a bloc wide default, the entire western banking system could grind to a halt while ramifications and damage were assessed; massive uncertainty and the loss of confidence in the international monetary system could spill over to destabilize financial relationships among all countries of the world.

-- Effective invocation of the clause could tend to drive Poland and other bloc countries further into the hands of the Soviets, both politically and economically. They would have nowhere else to turn.

-- Invoking the exceptional circumstances clause would ultimately tear down the institutional mechanisms which we have worked so hard over the postwar years to build and maintain: our monetary system; and the free flow of trade, investment, and capital.

-- Rather than reacting in a manner which injures these these institutions, we should choose any further retaliatory measures in a manner which makes it more expensive for the Soviets and the bloc countries to conduct their external trade and commerce with the West.

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-- In this regard, we are undertaking a review of the creditworthiness of the Soviet Union, Romania, Czechoslovakia, and Hungary.

-- We believe that the results of such a review will demonstrate what the market already knows: that the creditworthiness of these countries has slipped, and that it will become more expensive and more difficult for them to borrow.

-- The results of this review could be passed to the Bank regulation agencies and to central bankers in the G-5 meeting, January 17, 1981, for any action they may deem appropriate.

-- The upshot of this course of action is that the threat of invoking the tank clause remains in place as a vehicle for exerting influence over our allies.

-- This threat can be made more credible if we can have Poland's other western creditors join with the U.S., France, the FRG, and the UK, in agreeing that conditions in Poland would justify use of the clause, without necessarily invoking it at this time.

-- This we expect to accomplish at a meeting in Paris, January 14-15. (Just before the G-5 meets.)

-- We also expect all creditors, official and private, to agree not to reschedule Poland's 1982 debts at this time.

-- Deferring official rescheduling for 1982 could also lead to deferral of rescheduling by the banks, thus setting into train a possible default situation for later in 1982, and in its own way putting considerable pressure on the Poles and the Soviets, without the imposition of the exceptional circumstances clause.

-- We believe, however, that rather than acting precipitously, banks and governments should to use the threat of default with its attendant effects on greatly reduced bloc access to western credit, as leverage against the Soviets to help achieve our broader political objectives.

-- Governments, and the financial markets, recognize that the USSR and E. Europe have become less creditworthy. Events, as they unfold, are producing many of the effects on the bloc that we seek, particularly the restriction of access to Western credit and an increase in its cost. The difference between this evolving reality and the potential impact that invoking the tank clause could have on the Western System is that the reality is, if not orderly, at least manageable short of chaos in the markets.

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